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Quarterly Review and Outlook

As we reach the midpoint of the year, investors are asking where is the recession? Last year economists and pundits were convinced that a recession was on the way as the Federal Reserve was steadfast in their resolve to curb inflation by aggressively raising interest rates and bringing inflation down to its target rate of 2%. Inflation peaked last year at 9% and as a result of the Fed's actions to slow the economy, it has since declined to 4.1% as of May. The core rate of inflation (excluding food and energy), which is where the Fed's focus lies, has slowed to a rate of 5.3%. Many economists believe the Fed has brought inflation down to a point where no further rate increases are needed. However, at their most recent meeting in June, Chairman Powell announced that the FOMC members had decided to "pause" or keep rates unchanged because the Fed members wanted to evaluate the effects on the economy and inflation from their cumulative 500 basis point rate rise since March of last year. He noted that while inflation had come down from peak levels last year, it was still a long way off from their stated target level of 2%. He also warned that this pause should not be interpreted as the Fed having completed its monetary tightening task. In fact, he noted that in the continuing fight against inflation, "Nearly all FOMC participants expect that it will be appropriate to raise interest rates somewhat further by the end of the year." Ongoing Fed tightening, if it occurs, has historically been a head wind to the price/earnings multiples afforded stocks and a headwind to stock performance.

Despite the Federal Reserve continuing to raise rates, and their message that a few more rate hikes are likely following their current pause, the U.S. economy has remained amazingly resilient and impervious to the higher interest rates and tightening lending standards that are usually associated with a recession. The stock market also seems to be questioning the Fed's resolve with investors coming to believe that perhaps the Fed will not be overly aggressive with rate cuts and may be able to orchestrate a soft landing in the economy and avoid a recession. As a result, investors bid up stock prices in the second quarter. The S&P 500 was up 8.7% and year to date the market is up 16.9%. The outperformance in stock prices has been concentrated in the mega cap technology names such as Apple, Microsoft, Alphabet (Google), Amazon, Meta (Facebook), Netflix, Nvidia and Tesla. These stocks experienced significant corrections in 2022 and, as a result, their management teams made a concerted effort to cut costs, including headcount reductions. With lower valuations, large positions of cash on their balance sheets and the promise of expansive growth with the advent of Artificial Intelligence (AI), these companies in 2023 were viewed by investors as being more defensive and capable of weathering a downturn in the economy (should it occur). AI was viewed as an additional growth driver. As a result, investors aggressively purchased shares, driving up the mega caps' stock prices. The valuations of these mega cap technology companies have come roaring back from the lows of 2022. The question now becomes will these mega cap stocks continue their outperformance or will the stocks in other areas begin to catch up?

Ironically, as the Fed has been trying to tighten monetary conditions, overall financial conditions have eased. The factors contributing to this dichotomy have been lower energy prices and a strong job market. Europe was able to secure energy supplies to replace Russian gas more easily than expected. The jobs market in the U.S. has proven to be far less sensitive to interest rates than economists thought and those who are employed have been getting raises which have kept up with or exceeded inflation. Companies and consumers locked in long dated loans with low rates during the pandemic and many households still have residual savings left over from the stimulus checks that were disbursed during the pandemic. All these factors have supported consumption and business.

Even in a growing economy, corporate management teams have been conservative in their spending, heeding the call of possible recession. They have done a good job of managing their expenses and reigning in costs which has resulted in first quarter earnings and margins coming in better than expected. In early July companies will begin reporting their 2nd quarter earnings. We will be listening closely to what management teams have to say, particularly regarding their forecasts and guidance for the back half of this year and 2024. Historically it has taken about 12-18 months for the effect of rising interest rates to be felt in the economy and corporate earnings. The Federal Reserve began raising interest rates about 15 months ago, so we are at the point now where we should be seeing the impact, if any. In this environment, we remain defensive in our posture. We continue to look for companies with durable business models, strong balance sheets, sustainable cash flows and the ability to self-fund growth. Our equity focus remains in technology, health care, industrial and select financial and consumer areas.

Higher interest rates have made for more compelling current returns in the fixed income area. For the first time in years, cash is earning a return over 4%. We have welcomed the increased income for our clients and have increased our exposure to short-dated Treasury Bills as an alternative to lower paying money market funds. To secure higher income on a longer-term basis, we are also looking at opportunities in the bond market. We have remained steadfast with our preference for investment grade rated securities and continue to favor corporate credits with strong balance sheets and state and municipalities with strong finances.

As always, we are grateful for the support of our clients and encourage you to reach out to us with any questions or concerns regarding your investments.